APPENDIX B

CONFERENCE OF STATE BANK SUPERVISORS AND AMERICAN ASSOCIATION OF RESIDENTIAL MORTGAGE REGULATORS GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

CONFERENCE OF STATE BANK SUPERVISORS

AMERICAN ASSOCIATION OF RESIDENTIAL MORTGAGE REGULATORS

GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

I. INTRODUCTION

On October 4, 2006, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (collectively, the Agencies) published final guidance in the *Federal Register* (Volume 71, Number 192, Page 58609-58618) on nontraditional mortgage product risks ("interagency guidance"). The interagency guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.

Recognizing that the interagency guidance does not cover a majority of loan originations, on June 7, 2006 the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) announced their intent to develop parallel guidance. Both CSBS and AARMR strongly support the purpose of the guidance adopted by the Agencies and are committed to promote uniform application of its consumer protections for all borrowers.

The following guidance will assist state regulators of mortgage brokers and mortgage companies (referred to as "providers") not affiliated with a bank holding company or an insured financial institution to promote consistent regulation in the mortgage market and clarify how providers can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume.

In order to maintain regulatory consistency, this guidance substantially mirrors the interagency guidance, except for the deletion of sections not applicable to non-depository institutions.

II. BACKGROUND

The Agencies developed their guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as "nontraditional," "alternative," or "exotic" mortgage loans (hereinafter referred to as nontraditional mortgage loans), include "interest-only" mortgages and "payment option" adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

While similar products have been available for many years, the number of institutions and providers offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages. CSBS and AARMR are concerned that some borrowers may not fully understand the risks of these products. While many of these risks exist in other adjustable-rate mortgage products, the concern of CSBS and AARMR is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In addition, providers are increasingly combining these loans with other features that may compound risk. These features include simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant's creditworthiness.

III. TEXT OF FINAL CSBS-AARMR GUIDANCE

The text of the final CSBS-AARMR Guidance on Nontraditional Mortgage Product Risks follows:

CSBS-AARMR GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "payment option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.[1]

While some providers have offered nontraditional mortgages for many years with appropriate risk management, the market for these products and the number of providers offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements ("reduced documentation") and are increasingly

[1] Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit ("HELOCs"), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

combined with simultaneous second-lien loans.[2] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes providers to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The XXX APPROPRIATE STATE AGENCY expects providers to effectively assess and manage the risks associated with nontraditional mortgage loan products.

Providers should use this guidance to ensure that risk management practices adequately address these risks. The XXX APPROPRIATE STATE AGENCY will carefully scrutinize risk management processes, policies, and procedures in this area. Providers that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Providers with sound underwriting, and adequate risk management will not be subject to criticism merely for offering such products.

Loan Terms and Underwriting Standards

When a provider offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins.

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Providers are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualifying Borrowers—Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some providers manage the potential for excessive negative amortization and payment shock by structuring the initial terms to

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[2] Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, a provider's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that a provider's underwriting criteria are based on multiple factors, a provider should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, a provider's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,[3] assuming a fully amortizing repayment schedule.[4] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[5]

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans—Providers should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral

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[3] The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

[4] The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

[5] The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

pledged may be unfair and abusive.[6] Providers that originate collateral-dependent mortgage loans may be subject to criticism and corrective action.

Risk Layering—Providers that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, a provider should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation—Providers increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, it is expected that a provider will more diligently verify and document a borrower's income and debt reduction capacity. Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, providers generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans—Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

Introductory Interest Rates—Many providers offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing nontraditional mortgage product terms, a provider should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Providers should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

[6] A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

Lending to Subprime Borrowers—Providers of mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should ensure that such programs do not feature terms that could become predatory or abusive. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the provider and the borrower.

Non-Owner-Occupied Investor Loans—Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

Risk Management Practices

Providers should ensure that risk management practices keep pace with the growth of nontraditional mortgage products and changes in the market. Providers that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, providers should:

- Develop written policies that specify acceptable product attributes, production, sales and securitization practices, and risk management expectations; and
- Design enhanced performance measures and management reporting that provide early warning for increasing risk.

Policies—A provider's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, a provider should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations—Providers with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Further, providers should consider the effect of employee and third party incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls—A provider's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Third-Party Originations—Providers often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Providers should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the provider's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help providers identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the provider should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.

Secondary Market Activity—The sophistication of a provider's secondary market risk management practices should be commensurate with the nature and volume of activity. Providers with significant secondary market activities should have comprehensive, formal strategies for managing risks. Contingency planning should include how the provider will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, a provider remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, a provider may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets.

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, XXX APPROPRIATE STATE AGENCY is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, providers should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

Concerns and Objectives—More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the provider.

Legal Risks—Providers that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that providers must provide for closed-end mortgages in advertisements, with an application,[7] before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the sale or securitization of a loan may not affect a provider's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, may apply.

[7] These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[8]

Communications with Consumers—When promoting or describing nontraditional mortgage products, providers should give consumers information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, providers should give consumers information at a time that will help consumers select products and choose among payment options. For example, providers should offer clear and balanced product descriptions when a consumer is shopping for a mortgage—such as when the consumer makes an inquiry to the provider about a mortgage product and receives information about nontraditional products, or when marketing relating to nontraditional mortgage products is given by the provider to the consumer—not just upon the submission of an application or at consummation.[9] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.[10]

- *Promotional Materials and Product Descriptions*
  Promotional Materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

  - *Payment Shock.* Providers should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are

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[8] Providers also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

[9] Providers also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

[10] Providers may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, providers should provide clear and balanced information about the risks of these products in all forms of advertising.

required and the interest rate and negative amortization caps have been reached.[11] Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

- *Negative Amortization.* When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

- *Prepayment Penalties.* If the provider may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.

- *Cost of Reduced Documentation Loans.* If a provider offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

- *Monthly Statements on Payment Option ARMs*
  Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Providers should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

- *Practices to Avoid*

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[11] Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

Providers also should avoid practices that obscure significant risks to the consumer. For example, if a provider advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the provider also should give clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, providers should avoid promoting payment patterns that are structurally unlikely to occur.[12] Such practices could raise legal and other risks for providers.

Providers also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

Control Systems—Providers should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Providers should design control systems to address compliance and consumer information concerns as well as the risk management considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about the product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Providers should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that a provider makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the provider should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing

[12] For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, policies, or laws.

Appendix

Interest-Only Mortgage Loan—A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM—A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

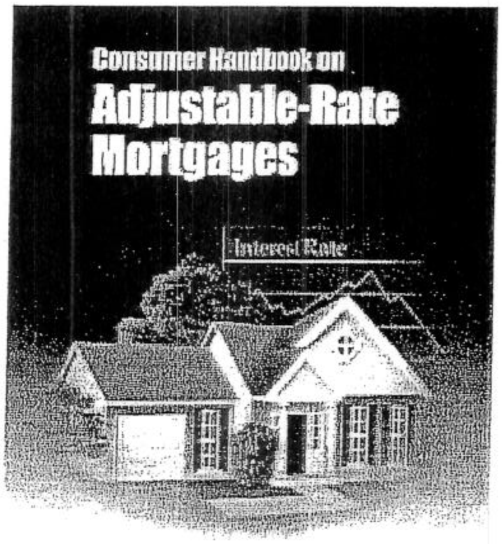
Reduced Documentation—A loan feature that is commonly referred to as "low doc/no doc," "no income/no asset," "stated income" or "stated assets." For mortgage loans with this feature, a provider sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan—A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

APPENDIX C

FEDERAL RESERVE BOARD CONSUMER HANDBOOK ON ADJUSTABLE RATE MORTGAGES

The Federal Reserve Board



Printable version (5 MB PDF)

Adjustable-rate mortgages (ARMs) are loans with interest rates that change. ARMs may start with lower monthly payments than fixed-rate mortgages, but keep the following in mind:

- Your monthly payments could change. They could go up--sometimes by a lot--even if interest rates don't go up.
- Your payments may not go down much, or at all--even if interest rates go down.
- You could end up owing more money than you borrowed--even if you make all your payments on time.
- If you want to pay off your ARM early to avoid higher payments, you might have to pay a penalty.

You need to compare features of ARMs to find the one that best fits your needs. See the Mortgage Shopping Worksheet.

This handbook explains how ARMs work and discusses some of the issues that borrowers may face. It includes ways to reduce the risks and gives some pointers about advertising and other ways you can get information from lenders and other trusted advisers. Important ARM terms are defined in a glossary. And the Mortgage Shopping Worksheet can help you ask the right questions and figure out whether an ARM is right for you. Ask lenders to help you fill out the worksheet so you can get the information you need to compare mortgages.

What Is an ARM?

An adjustable-rate mortgage differs from a fixed-rate mortgage in many ways. With a fixed-rate mortgage, the interest rate stays the same during the life of the loan. With an ARM, the interest rate changes periodically, usually in relation to an index, and payments may go up or down accordingly.

Shopping for a mortgage is not as simple as it used to be. To compare two ARMs with each other or to compare an ARM with a fixed-rate mortgage, you need to know about indexes, margins, discounts, caps on rates and payments, negative amortization, payment options, and recasting (recalculating) your loan. You need to consider the maximum amount your monthly payment could increase. Most important, you need to know what might happen to your monthly mortgage payment in relation to your future ability to afford higher payments.

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate mortgages. At first, this makes the ARM easier on your pocketbook than a fixed-rate mortgage for the same loan amount. Moreover, your ARM could be less expensive over a long period than a fixed-rate mortgage--for example, if interest rates remain steady or move lower.

Against these advantages, you have to weigh the risk that an increase in interest rates would lead to higher monthly payments in the future. It's a trade-off--you get a lower initial rate with an ARM in exchange for assuming more risk over the long run.

Here are some questions you need to consider:

- Is my income enough--or likely to rise enough--to cover higher mortgage payments if interest rates go up?
- Will I be taking on other sizable debts, such as a loan for a car or school tuition, in the near future?
- How long do I plan to own this home? (If you plan to sell soon, rising interest rates may not pose the problem they do if you plan to own the house for a long time.)
- Do I plan to make any additional payments or pay the loan off early?

Lenders and Brokers

Mortgage loans are offered by many kinds of lenders--such as banks, mortgage companies, and credit unions. You can also get a loan through a mortgage broker. Brokers "arrange" loans; in other words, they find a lender for you. Brokers generally take your application and contact several lenders, but keep in mind that brokers are not required to find the best deal for you unless they have contracted with you to act as your agent.

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How ARMs Work: The Basic Features

Initial rate and payment

The initial rate and payment amount on an ARM will remain in effect for a limited period of time--ranging from just 1 month to 5 years or more. For some ARMs, the initial rate and payment can vary greatly from the rates and payments later in the loan term. Even if interest rates are stable, your rates and payments could change a lot. If lenders or brokers quote the initial rate and payment on a loan, ask them for the annual percentage rate (APR). If the APR is significantly higher than the initial rate, then it is likely that your rate and payments will be a lot higher when the loan adjusts, even if general interest rates remain the same.

The adjustment period

With most ARMs, the interest rate and monthly payment change every month, quarter, year, 3 years, or 5 years. The period between rate changes is called the *adjustment period*. For example, a loan with an adjustment period of 1 year is called a 1-year ARM, and the interest rate and payment can change once every year; a loan with a 3-year adjustment period is called a 3-year ARM.

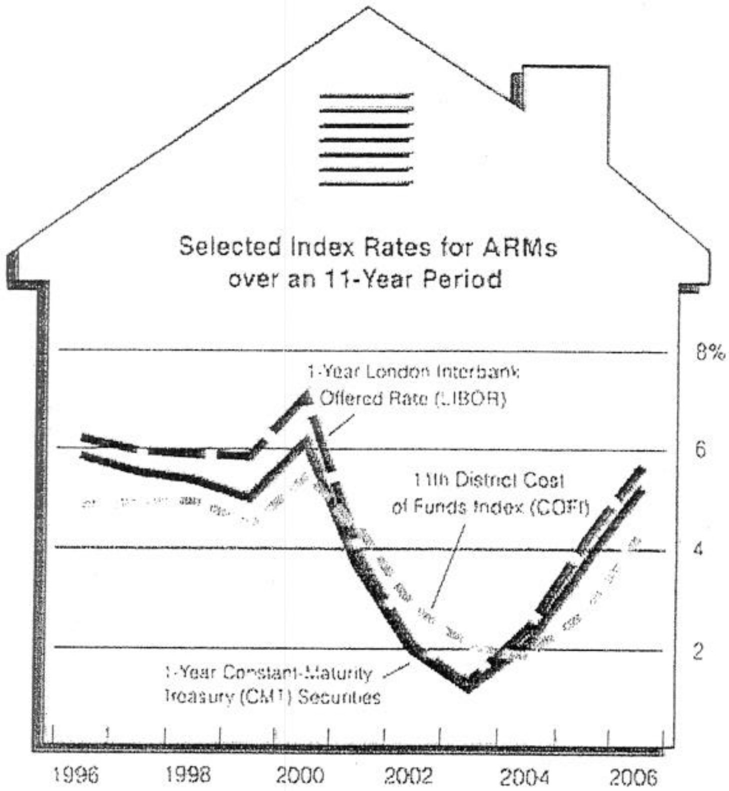
> **Loan Descriptions**
>
> Lenders must give you written information on each type of ARM loan you are interested in. The information must include the terms and conditions for each loan, including information about the index and margin, how your rate will be calculated, how often your rate can change, limits on changes (or *caps*), an example of how high your monthly payment might go, and other ARM features such as negative amortization.

The index

The interest rate on an ARM is made up of two parts: the index and the margin. The index is a measure of interest rates generally, and the margin is an extra amount that the lender adds. Your payments will be affected by any caps, or limits, on how high or low your rate can go. If the index rate moves up, so does your interest rate in most circumstances, and you will probably have to make higher monthly payments. On the other hand, if the index rate goes down, your monthly payment could go down. Not all ARMs adjust downward, however--be sure to read the information for the loan you are considering.

Lenders base ARM rates on a variety of indexes. Among the most common indexes are the rates on 1-year constant-maturity Treasury (CMT) securities, the Cost of Funds Index (COFI), and the London Interbank Offered Rate (LIBOR). A few lenders use their own cost of funds as an index, rather than using other indexes. You should ask what index will be used, how it has fluctuated in the past, and where it is published--you can find a lot of this information in major newspapers and on the Internet.

To help you get an idea of how to compare different indexes, the following chart shows a few common indexes over an 11-year period (1996-2006). As you can see, some index rates tend to be higher than others, and some change more often. But if a lender bases interest-rate adjustments on the average value of an index over time, your interest rate would not change as dramatically.



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The margin

To determine the interest rate on an ARM, lenders add a few percentage points to the index rate, called the *margin*. The amount of the margin may differ from one lender to another, but it is usually constant over the life of the loan. The *fully indexed rate* is equal to the margin plus the index. If the initial rate on the loan is less than the fully indexed rate, it is called a *discounted index rate*. For example, if the lender uses an index that currently is 4% and adds a 3% margin, the fully indexed rate would be

Index	**4%**
+Margin	**3%**
Fully indexed rate	**7%**

If the index on this loan rose to 5%, the fully indexed rate would be 8% (5% + 3%). If the index fell to 2%, the fully indexed rate would be 5% (2% + 3%).

Some lenders base the amount of the margin on your credit record--the better your credit, the lower the margin they add--and the lower the interest you will have to pay on your mortgage. In comparing ARMs, look at both the index and margin for each program.

> **No-Doc/Low-Doc Loans**
>
> When you apply for a loan, lenders usually require documents to prove that your income is high enough to repay the loan. For example, a lender might ask to see copies of your most recent pay stubs, income tax filings, and bank account statements. In a no-doc or low-doc loan, the lender doesn't require you to bring proof of your income, but you will usually have to pay a higher interest rate or extra fees to get the loan. Lenders generally charge more for no-doc/low-doc loans.

Interest-rate caps

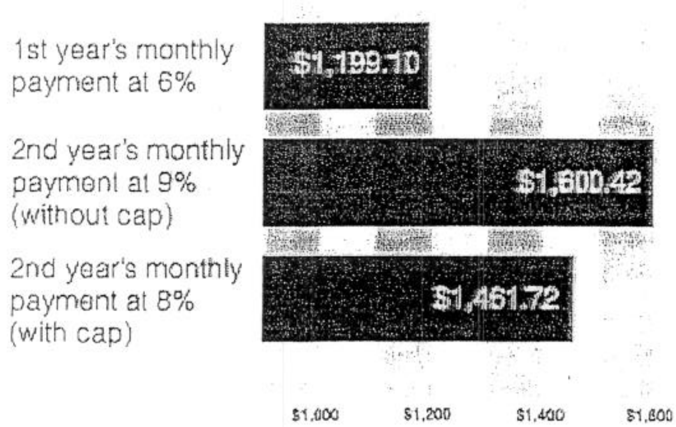
An interest-rate cap places a limit on the amount your interest rate can increase. Interest caps come in two versions:

- *periodic adjustment caps*, which limit the amount the interest rate can adjust up or down from one adjustment period to the next after the first adjustment, and
- *lifetime caps*, which limit the interest-rate increase over the life of the loan. By law, virtually all ARMs must have a lifetime cap.

Periodic adjustment caps

Let's suppose you have an ARM with a periodic adjustment interest-rate cap of 2%. However, at the first adjustment, the index rate has risen 3%. The following example shows what happens.

> **Examples in This Handbook**
>
> All examples in this handbook are based on a $200,000 loan amount and a 30-year term. Payment amounts in the examples do not include taxes, insurance, condominium or home-owner association fees, or similar items. These amounts can be a significant part of your monthly payment.



Difference in 2nd year between payment with cap and payment without = $138.70 per month

In this example, because of the cap on your loan, your monthly payment in year 2 is $138.70 per month lower than it would be without the cap, saving you $1,664.40 over the year.

Some ARMs allow a larger rate change at the first adjustment and then apply a periodic adjustment cap to all future adjustments.

A drop in interest rates does not always lead to a drop in your monthly payments. With some ARMs that have interest-rate caps, the cap may hold your rate and payment below what it would have been if the change in the index rate had been fully applied. The increase in the interest that was not imposed because of the rate cap might carry over to future rate adjustments. This is called *carryover*. So at the next adjustment date, your payment might increase even though the index rate has stayed the same or declined.

The following example shows how carryovers work. Suppose the index on your ARM increased 3% during the first year. Because this ARM limits rate increases to 2% at any one time, the rate is adjusted by only 2%, to 8% for the second year. However, the remaining 1% increase in the index carries over to the next time the lender can adjust rates. So when the lender adjusts the interest rate for the third year, the rate increases by 1%, to 9%, even if there is no change in the index during the second year.

In general, the rate on your loan can go up at any scheduled adjustment date when the lender's standard ARM rate (the index plus the margin) is higher than the rate you are paying before that adjustment.

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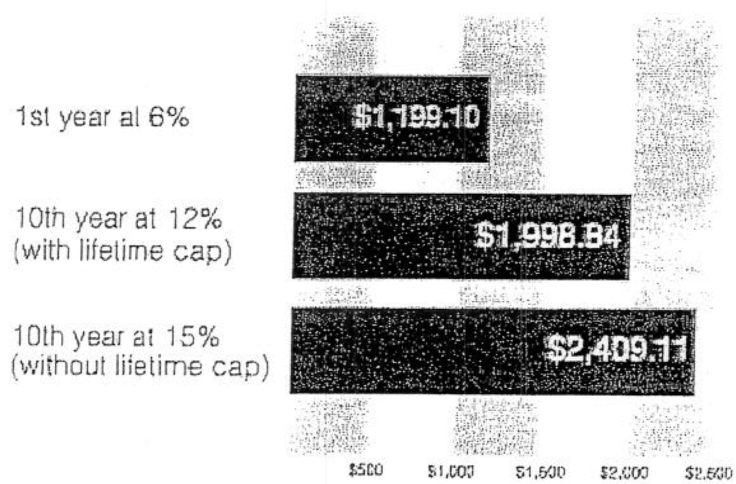
Lifetime caps

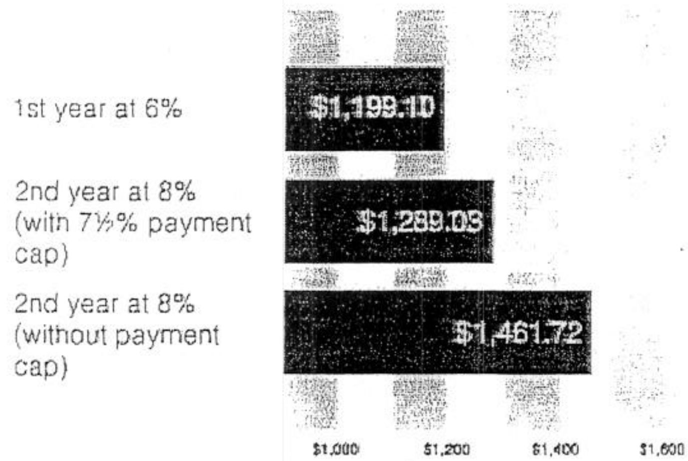
The next example shows how a lifetime rate cap would affect your loan. Let's say that your ARM starts out with a 6% rate and the loan has a 6% lifetime cap--that is, the rate can never exceed 12%. Suppose the index rate increases 1% in each of the next 9 years. With a 6% overall cap, your payment would never exceed $1,998.84--compared with the $2,409.11 that it would have reached in the tenth year without a cap.



Payment caps

In addition to interest-rate caps, many ARMs--including payment-option ARMs--limit, or cap, the amount your monthly payment may increase at the time of each adjustment. For example, if your loan has a payment cap of 7½%, your monthly payment won't increase more than 7½% over your previous payment, even if interest rates rise more. For example, if your monthly payment in year 1 of your mortgage was $1,000, it could only go up to $1,075 in year 2 (7½% of $1,000 is an additional $75). Any interest you don't pay because of the payment cap will be added to the balance of your loan. A payment cap can limit the increase to your monthly payments but also can add to the amount you owe on the loan. (This is called *negative amortization*.)

Let's assume that your rate changes in the first year by 2 percentage points but your payments can increase no more than 7½% in any one year. The following graph shows what your monthly payments would look like.



Difference in monthly payment = $172.69

While your monthly payment will be only $1,289.03 for the second year, the difference of $172.69 each month will be added to the balance of your loan and will lead to negative amortization.

Some ARMs with payment caps do not have periodic interest-rate caps. In addition, as explained below, most payment-option ARMs have a built-in recalculation period, usually every 5 years. At that point, your payment will be recalculated (lenders use the term *recast*) based on the remaining term of the loan. If you have a 30-year loan and you are at the end of year 5, your payment will be recalculated for the remaining 25 years. The payment cap does not apply to this adjustment. If your loan balance has increased, or if interest rates have risen faster than your payments, your payments could go up a lot.

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Types of ARMs

Hybrid ARMs

Hybrid ARMs often are advertised as 3/1 or 5/1 ARMs--you might also see ads for 7/1 or 10/1 ARMs. These loans are a mix--or a hybrid--of a fixed-rate period and an adjustable-rate period. The interest rate is fixed for the first few years of these loans--for example, for 5 years in a 5/1 ARM. After that, the rate may adjust annually (the 1 in the 5/1 example), until the loan is paid off. In the case of 3/1 or 5/1 ARMs

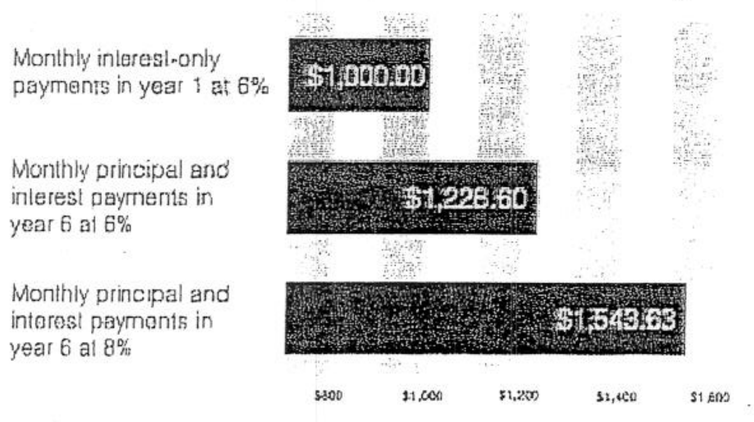
- the first number tells you how long the fixed interest-rate period will be and
- the second number tells you how often the rate will adjust after the initial period.

You may also see ads for 2/28 or 3/27 ARMs--the first number tells you how long the fixed interest-rate period will be, and the second number tells you the number of years the rates on the loan will be adjustable. Some 2/28 and 3/27 mortgages adjust every 6 months, not annually.

Interest-only ARMs

An interest-only (I-O) ARM payment plan allows you to pay only the interest for a specified number of years, typically between 3 and 10 years. This allows you to have smaller monthly payments for a period of time. After that, your monthly payment will increase--even if interest rates stay the same--because you must start paying back the principal as well as the interest each month. For some I-O loans, the interest rate adjusts during the I-O period as well.

For example, if you take out a 30-year mortgage loan with a 5-year I-O payment period, you can pay only interest for 5 years and then you must pay both the principal and interest over the next 25 years. Because you begin to pay back the principal, your payments increase after year 5, even if the rate stays the same. Keep in mind that the longer the I-O period, the higher your monthly payments will be after the I-O period ends.



Payment-option ARMs

A payment-option ARM is an adjustable-rate mortgage that allows you to choose among several payment options each month. The options typically include the following:

- *a traditional payment of principal and interest*, which reduces the amount you owe on your mortgage. These payments are based on a set loan term, such as a 15-, 30-, or 40-year payment schedule.
- *an interest-only payment*, which pays the interest but does not reduce the amount you

owe on your mortgage as you make your payments.

- *a minimum (or limited) payment* that may be less than the amount of interest due that month and may not reduce the amount you owe on your mortgage. If you choose this option, the amount of any interest you do not pay will be added to the principal of the loan, **increasing the amount you owe and your future monthly payments**, and increasing the amount of interest you will pay over the life of the loan. In addition, if you pay only the minimum payment in the last few years of the loan, you may owe a larger payment at the end of the loan term, called a *balloon payment*.

The interest rate on a payment-option ARM is typically very low for the first few months (for example, 2% for the first 1 to 3 months). After that, the interest rate usually rises to a rate closer to that of other mortgage loans. Your payments during the first year are based on the initial low rate, meaning that if you only make the minimum payment each month, it will not reduce the amount you owe and it may not cover the interest due. The unpaid interest is added to the amount you owe on the mortgage, and your loan balance increases. This is called *negative amortization*. This means that even after making many payments, you could owe more than you did at the beginning of the loan. Also, as interest rates go up, your payments are likely to go up.

Payment-option ARMs have a built-in recalculation period, usually every 5 years. At this point, your payment will be recalculated (lenders use the term *recast*) based on the remaining term of the loan. If you have a 30-year loan and you are at the end of year 5, your payment will be recalculated for the remaining 25 years. If your loan balance has increased because you have made only minimum payments, or if interest rates have risen faster than your payments, your payments will increase each time your loan is recast. At each recast, your new minimum payment will be a fully amortizing payment and any payment cap will not apply. This means that your monthly payment can increase a lot at each recast.

Lenders may recalculate your loan payments before the recast period if the amount of principal you owe grows beyond a set limit, say 110% or 125% of your original mortgage amount. For example, suppose you made only minimum payments on your $200,000 mortgage and had any unpaid interest added to your balance. If the balance grew to $250,000 (125% of $200,000), your lender would recalculate your payments so that you would pay off the loan over the remaining term. It is likely that your payments would go up substantially.

More information on interest-only and payment-option ARMs is available in the Federal Reserve Board's brochure titled *Interest-Only Mortgage Payments and Payment-Option ARMs--Are They for You?*

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Consumer Cautions

Discounted interest rates

Many lenders offer more than one type of ARM. Some lenders offer an ARM with an initial rate that is lower than their fully indexed ARM rate (that is, lower than the sum of the index plus the margin). Such rates--called discounted rates, start rates, or teaser rates--are often combined with large initial loan fees, sometimes called *points*, and with higher rates after the initial discounted rate expires.

Your lender or broker may offer you a choice of loans that may include "discount points" or a "discount fee." You may choose to pay these points or fees in return for a lower interest rate. But keep in mind that the lower interest rate may only last until the first adjustment.

If a lender offers you a loan with a discount rate, don't assume that means that the loan is a good one for you. You should carefully consider whether you will be able to afford higher payments in later years when the discount expires and the rate is adjusted.

Here is an example of how a discounted initial rate might work. Let's assume that the lender's fully indexed one-year ARM rate (index rate plus margin) is currently 6%; the monthly payment for the first year would be $1,199.10. But your lender is offering an ARM with a discounted initial rate of 4% for the first year. With the 4% rate, your first-year's monthly payment would be $954.83.

With a discounted ARM, your initial payment will probably remain at $954.83 for only a limited time--and any savings during the discount period may be offset by higher payments over the remaining life of the mortgage. If you are considering a discount ARM, be sure to compare future payments with those for a fully indexed ARM. In fact, if you buy a home or refinance using a deeply discounted initial rate, you run the risk of payment shock, negative amortization, or prepayment penalties or conversion fees.

Payment shock

Payment shock may occur if your mortgage payment rises sharply at a rate adjustment. Let's see what would happen in the second year if the rate on your discounted 4% ARM were to rise to the 6% fully indexed rate.

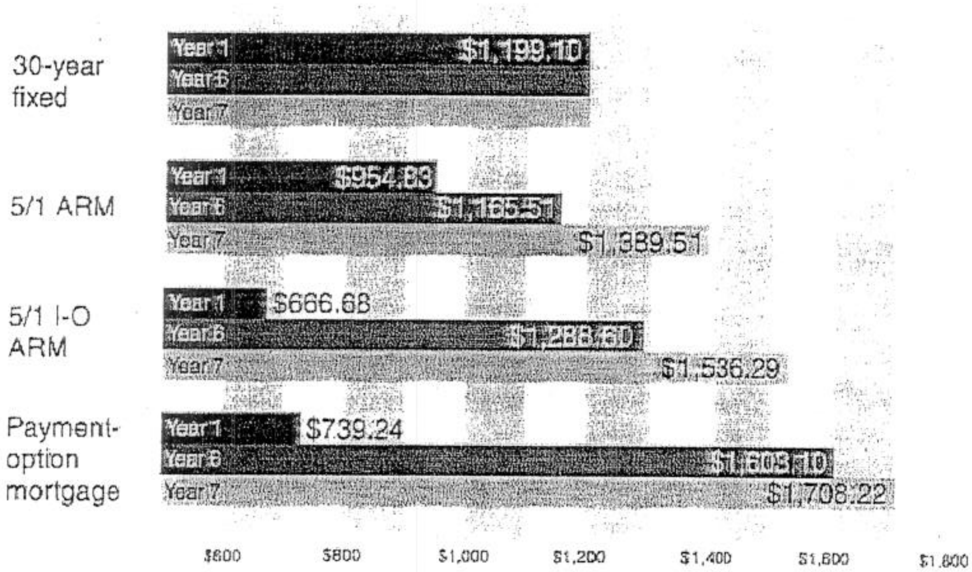
As the example shows, even if the index rate were to stay the same, your monthly payment would go up from $954.83 to $1,192.63 in the second year.

Suppose that the index rate increases 1% in one year and the ARM rate rises to 7%. Your payment in the second year would be $1,320.59.

That's an increase of $365.76 in your monthly payment. You can see what might happen if you choose an ARM because of a low initial rate without considering whether you will be able to afford future payments.

If you have an interest-only ARM, payment shock can also occur when the interest-only period ends. Or, if you have a payment-option ARM, payment shock can happen when the loan is recast.

The following example compares several different loans over the first 7 years of their terms; the payments shown are for years 1, 6, and 7 of the mortgage, assuming you make interest-only payments or minimum payments. The main point is that, depending on the terms and conditions of your mortgage and changes in interest rates, ARM payments can change quite a bit over the life of the loan--so while you could save money in the first few years of an ARM, you could also face much higher payments in the future.



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Negative amortization--When you owe more money than you borrowed

Negative amortization means that the amount you owe increases even when you make all your required payments on time. It occurs whenever your monthly mortgage payments are not large enough to pay all of the interest due on your mortgage--the unpaid interest is added to the principal on your mortgage, and you will owe more than you originally borrowed. This can happen because you are making only minimum payments on a payment-option mortgage or because your loan has a payment cap.

For example, suppose you have a $200,000, 30-year payment-option ARM with a 2% rate for the first 3 months and a 6% rate for the remaining 9 months of the year. Your minimum payment for the year is $739.24, as shown in the graph above. However, once the 6% rate is applied to your loan balance, you are no longer covering the interest costs. If you continue to make minimum payments on this loan, your loan balance at the end of the first year of your mortgage would be $201,118--or $1,118 more than you originally borrowed.

Because payment caps limit only the amount of payment increases, and not interest-rate increases, payments sometimes do not cover all the interest due on your loan. This means that the unpaid interest is automatically added to your debt, and interest may be charged on that amount. You might owe the lender more later in the loan term than you did at the beginning.

A payment cap limits the increase in your monthly payment by deferring some of the interest. Eventually, you would have to repay the higher remaining loan balance at the interest rate then in effect. When this happens, there may be a substantial increase in your monthly payment.

Some mortgages include a cap on negative amortization. The cap typically limits the total amount you can owe to 110% to 125% of the original loan amount. When you reach that point, the lender will set the monthly payment amounts to fully repay the loan over the remaining term. Your payment cap will not apply, and your payments could be substantially higher. You may limit negative amortization by voluntarily increasing your monthly payment.

Be sure you know whether the ARM you are considering can have negative amortization.

Home Prices, Home Equity, and ARMs

Sometimes home prices rise rapidly, allowing people to quickly build equity in their homes. This can make some people think that even if the rate and payments on their ARM get too high, they can avoid those higher payments by refinancing their loan or, in the worst case, selling their home. It's important to remember that home prices do not always go up quickly--they may increase a little or remain the same, and sometimes they fall. If housing prices fall, your home may not be worth as much as you owe on the mortgage. Also, you may find it difficult to refinance your loan to get a lower monthly payment or rate. Even if home prices stay the same, if your loan lets you make minimum payments (see *payment-option ARMs*), you may owe your lender more on your mortgage than you could get from selling your home.

Prepayment penalties and conversion

If you get an ARM, you may decide later that you don't want to risk any increases in the interest rate and payment amount. When you are considering an ARM, ask for information about any extra fees you would have to pay if you pay off the loan early by refinancing or selling your home, and whether you would be able to convert your ARM to a fixed-rate mortgage.

Prepayment penalties

Some ARMs, including interest-only and payment-option ARMs, may require you to pay special fees or penalties if you refinance or pay off the ARM early (usually within the first 3 to 5 years of the loan). Some loans have *hard prepayment penalties*, meaning that you will pay an extra fee or penalty if you pay off the loan during the penalty period for any reason (because you refinance or sell your home, for example). Other loans have *soft prepayment penalties*, meaning that you will pay an extra fee or penalty only if you refinance the loan, but you will not pay a penalty if you sell your home. Also, some loans may have prepayment penalties even if you make only a partial prepayment.

Prepayment penalties can be several thousand dollars. For example, suppose you have a 3/1 ARM with an initial rate of 6%. At the end of year 2 you decide to refinance and pay off your original loan. At the time of refinancing, your balance is $194,936. If your loan has a prepayment penalty of 6 months' interest on the remaining balance, you would owe about $5,850.

Sometimes there is a trade-off between having a prepayment penalty and having lower origination fees or lower interest rates. The lender may be willing to reduce or eliminate a prepayment penalty based on the amount you pay in loan fees or on the interest rate in the loan contract.

If you have a hybrid ARM--such as a 2/28 or 3/27 ARM--be sure to compare the prepayment penalty period with the ARM's first adjustment period. For example, if you have a 2/28 ARM that has a rate and payment adjustment after the second year, but the prepayment penalty is in effect for the first 5 years of the loan, it may be costly to refinance when the first adjustment is made.

Most mortgages let you make additional principal payments with your monthly payment. In most cases, this is *not* considered prepayment, and there usually is no penalty for these extra amounts. Check with your lender to make sure there is no penalty if you think you might want to make this type of additional principal prepayment.

Conversion fees

Your agreement with the lender may include a clause that lets you convert the ARM to a fixed-rate mortgage at designated times. When you convert, the new rate is generally set using a formula given in your loan documents.

The interest rate or up-front fees may be somewhat higher for a convertible ARM. Also, a convertible ARM may require a fee at the time of conversion.

Graduated-payment or stepped-rate loans

Some fixed-rate loans start with one rate for one or two years and then change to another rate for the remaining term of the loan. While these are not ARMs, your payment will go up according to the terms of your contract. Talk with your lender or broker and read the information provided to you to make sure you understand when and by how much the payment will change.

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Where to Get Information

Disclosures from lenders

You should receive information in writing about each ARM program you are interested in before you have paid a nonrefundable fee. It is important that you read this information and ask the lender or broker about anything you don't understand--index rates, margins, caps, and other ARM features such as negative amortization. After you have applied for a loan, you will get more information from the lender about your loan, including the APR, a payment schedule, and whether the loan has a prepayment penalty.

The APR is the cost of your credit as a yearly rate. It takes into account interest, points paid on the loan, any fees paid to the lender for making the loan, and any mortgage insurance premiums you may have to pay. You can compare APRs on similar ARMs (for example, compare APRs on a 5/1 and a 3/1 ARM) to determine which loan will cost you less in the long term, but you should keep in mind that because the interest rate for an ARM can change, APRs on ARMs cannot be compared directly to APRs for fixed-rate mortgages.

You may want to talk with financial advisers, housing counselors, and other trusted advisers. Contact a local housing counseling agency, call the U.S. Department of Housing and Urban Development toll-free at 800-569-4287, or visit online to find a center near you.

Newspapers and the Internet

When buying a home or refinancing your existing mortgage, remember to shop around. Compare costs and terms, and negotiate for the best deal. Your local newspaper and the Internet are good places to start shopping for a loan. You can usually find information on interest rates and points for several lenders. Since rates and points can change daily, you'll want to check information sources often when shopping for a home loan.

The Mortgage Shopping Worksheet may also help you. Take it with you when you speak to each lender or broker and write down the information you obtain. Don't be afraid to make lenders and brokers compete with each other for your business by letting them know that you are shopping for the best deal.

Advertisements

Any initial information you receive about mortgages probably will come from advertisements or mail solicitations from builders, real estate brokers, mortgage brokers, and lenders. Although this information can be helpful, keep in mind that these are marketing materials--the ads and mailings are designed to make the mortgage look as attractive as possible. These ads may play up low initial interest rates and monthly payments, without emphasizing that those rates and payments could increase substantially later. So, get all the facts.

Any ad for an ARM that shows an initial interest rate should also show how long the rate is in effect and the APR on the loan. If the APR is much higher than the initial rate, your payments may increase a lot after the introductory period, even if interest rates stay the same.

Choosing a mortgage may be the most important financial decision you will make. You are entitled to have all the information you need to make the right decision. Don't hesitate to ask questions about ARM features when you talk to lenders, mortgage brokers, real estate agents, sellers, and your attorney, and keep asking until you get clear and complete answers.

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The information on this site is also available in the brochure "Consumer Handbook on Adjustable-Rate Mortgages." Single or multiple copies of the brochure are available without charge. Order the brochure by telephone, mail, or fax. Order online.

Glossary | Mortgage Shopping Worksheet | For More Information

Last update: January 5, 2007